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August 11, 2006

AGENDA ITEM 4b

TO: MEMBERS OF THE INVESTMENT POLICY SUBCOMMITTEE

I. SUBJECT: Revision of Corporate Governance Principles and Guidelines

II. PROGRAM: Global Equity

III. RECOMMENDATION: Recommend to the Investment Committee approval of the revised CalPERS' Corporate Governance Core Principles & Guidelines to add a new executive compensation provision that addresses option backdating.

IV. ANALYSIS:

Executive Summary

At its June 20, 2006 meeting, the Investment Committee directed staff to amend CalPERS' Corporate Governance Core Principles & Guidelines (Principles) to address recent issues relating to stock option backdating.

This agenda item seeks Committee approval to amend Appendix D, Executive Compensation Policies, of CalPERS' Principles by adding the following provision:

Expected equity grant issue dates should be pre-established, set, and disclosed by the compensation committee. Realized grant dates should be publicly disclosed at the latest on the day following the date of grant. The rationale for any amendment to pre-established grant dates should be disclosed with justification describing how the amendment benefits shareowners.

- Attachment 1 includes CalPERS' Corporate Governance Core Principles and Guidelines with amendments to Appendix D Executive Compensation Policies.

Background

At its March 13, 2006 meeting, the Investment Committee approved amendments to CalPERS' Principles by adding Appendix D Executive Compensation Policies to reflect provisions that should be addressed when companies design compensation policies. On June 19, 2006, the Committee directed staff to amend its principles to address issues related to stock option backdating.

Backdating is the practice of changing an option's grant date from the date it actually was granted to another date when the issue price is lower. This practice is not necessarily illegal if accurate financial statement recordkeeping is maintained related to earnings and tax reporting. However, intentional option grant date timing changes that are for the purpose of bolstering executive compensation packages is an inappropriate practice and subjects the company to significant regulatory, legal, and economic risk.

Egregious executive compensation misconduct related to option grant timing has threatened the credibility and sustainable value creation for a number of CalPERS' portfolio companies. To date, CalPERS has submitted letters to 40 companies recommending specific action be taken to address SEC investigations into option backdating allegations. There is no way to determine the total number of companies that could potentially be linked to egregious option backdating practices going forward. However, the negative implications that could arise at companies that do not provide adequate, accurate, and timely disclosure of option grant dates include:

- Regulatory or internal investigations that take management time and attention away from creating long-term shareowner value.
- Executive and director turnover that poses significant risk to sustainable value creation.
- Material financial restatements as a result of inappropriate use of tax deductions and levying of tax penalties.
- Shareowner lawsuits resulting in significant financial penalties or settlements.
- Exchange delisting for violations of listing standard requirements.

Analysis

In order to minimize the negative implications that could arise from egregious option backdating schemes, executive compensation policies should include specific equity compensation grant date provisions that uphold the use of adequate, accurate, and timely disclosure to shareowners.

Legislative mandates stemming from the Sarbanes-Oxley Act in 2002 have largely reduced the window of opportunity for companies to manipulate executive compensation practices related to option grant dates. In response to changes mandated by the Act, companies must now disclose to the SEC option grants within two business days of the company making the grant.

Prior to Sarbanes-Oxley, companies were not required to disclose option grants until 45 days after the company's fiscal year end. This lengthy filing period provided companies a broad window of time to retroactively tie option grant dates with stock price lows. With the 2002 legislative change, the opportunities for backdating option grants are greatly reduced.

Reducing opportunities for egregious option backdating schemes can be further accomplished by instituting disciplined provisions for pre-establishing and publicly disclosing expected equity grant patterns. The process for determining and ultimately setting the actual equity grant dates should fall under the oversight of the compensation committee. Disclosing specific expected grant dates prior to compensation periods, such as those dates coinciding with company board meetings or the annual meeting, will establish regular patterns that may help remove suspicions of questionable grant timing.

While equity compensation provisions that disclose regular pre-established grant date patterns should be the norm, compensation committees should also be allowed to maintain the flexibility to establish grant dates that fall outside of pre-established dates. For example, the ability to provide an equity grant on a date that falls outside of pre-established dates could be necessary in cases that coincide with the start date of newly hired executives. At a minimum, any such deviation from the normal grant pattern should be disclosed along with justification of how the deviation is a benefit to the company as well as to long-term shareowner interests.

Regardless of whether or not pre-established option grant dates are disclosed, publicly traded companies must currently disclose to the SEC recipients of option grants within two business days of receiving the grant. However, a recent 2006 study[1] suggests that reporting requirements have greatly curbed backdating, but have not eliminated it. To eliminate backdating, the study suggests that the requirements need to be tightened further, such that option grants have to be reported on the grant day or, at the latest, on the following day with enforcement from the SEC.

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[1] See Randall A. Heron of the Kelley School of Business Indiana University; Erik Lie of the Henry B. Tippie College of Business University of Iowa, "Does backdating explain the stock price pattern around executive stock option grants?" (Forthcoming, Journal of Financial Economics)

Therefore, while SEC regulations currently require two-day reporting requirements, Staff believes companies should not only ensure that appropriate internal controls are in place to meet timely filing requirements but should also strive to meet disclosure requirements to go above the minimum acceptable filing standards.

Next Steps

Upon approval by the Investment Policy Subcommittee and the Investment Committee, Staff will update CalPERS' Corporate Governance Core Principles & Guidelines by adding the following provision to Appendix D, sub-section C. Equity Compensation:

- 4. Expected equity grant issue dates should be pre-established, set, and disclosed by the compensation committee. Realized grant dates should be publicly disclosed at the latest on the day following the date of grant. The rationale for any amendment to pre-established grant dates should be disclosed with justification describing how the amendment benefits shareowners.

V. STRATEGIC PLAN:

This item is consistent with the Strategic Plan: Goal I, exercise global leadership to ensure the sustainability of CalPERS' pension and health benefit systems.

VI. RESULTS/COSTS:

Costs associated with this item are expected to be minimal and can be absorbed within the Investment Office budget.

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